

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

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In the Matter of:

THE APPLICATION OF LESLIE COUNTY)
TELEPHONE COMPANY, INC., FOR)
ORDER AUTHORIZING ADJUSTMENT OF) CASE NO. 9002
RATES AND CHARGES)

O R D E R

On March 29, 1984, Leslie County Telephone Company, Inc., ("Leslie County") filed its application with the Commission to increase its rates and charges for telephone service to produce an annual increase in revenue of \$287,632. Leslie County stated that the increase was necessary to recognize the effects of its ongoing construction program and specifically to pay the interest on its long-term indebtedness, to meet operating expenses, and to provide new service for 1,732 customers.

On September 18 and September 19, 1983, the Commission held a public hearing to determine the reasonableness of Leslie County's request. The Consumer Protection Division of the Attorney General's Office ("AG") intervened and participated in the hearing. In this Order the Commission has allowed no increase in operating revenues.

COMMENTARY

The majority of Leslie County's rate case was prepared by Leslie County personnel without technical assistance from outside professional services. Leslie County stated that its efforts

resulted in reduced costs to the ratepayers. While the Commission commends Leslie County's intentions in this regard, the Commission notes numerous problems with the financial data filed by Leslie County. For instance, the financial data included in Leslie County's application differed in many respects from the financial data included in Leslie County's 1983 Annual Report submitted to the Commission.¹ In addition, Leslie County's application included a pro forma statement of income and expenses based on projected increases in various accounts and unsubstantiated by known and measurable adjustments to test period expenses.² At the hearing, Leslie County's witness admitted that Leslie County was informed of the Commission's policy of allowing only known and measurable adjustments to test period expenses but could offer no basis upon which to substantiate the pro forma statement of income and expenses.³ The Commission has attempted to correct some of the problems with the financial data, in part by requesting substantial additional information at the hearing. Leslie County complied with the majority of the Commission's requests and also provided an income statement analysis for 1983 to reconcile the differences in data between the application, the 1983 Annual

¹ Refer to Commission's first Staff Request, Item 23.

² Refer to application filed March 29, 1984, "Pro forma Statement of Income and Expenses."

³ Transcript of Evidence ("T.E."), September 18, 1984, pages 69 and 70.

Report, and a subsequent audit of 1983 results.⁴ The Commission notes that even this reconciliation contained discrepancies between amounts originally reported in the 1983 Annual Report and the amounts listed on the reconciliation as being contained on the 1983 Annual Report, although the bottom-line results did not change.⁵

Based on a review of the data filed in this case, much of which was filed with no support or workpapers to justify the pro forma level of revenues and expenses, the Commission finds no basis upon which to accept Leslie County's pro forma statement. Therefore, the Commission will use Leslie County's audited financial results as the appropriate starting point in this instance. The Commission advises Leslie County to better familiarize itself with the Commission's rate-making policies and to seek technical assistance if necessary to prevent the complexities experienced in this case from occurring in subsequent rate cases.

⁴ Refer to response to Question 8, filed October 25, 1984, "Income Statement Analysis for 1983."

⁵ See, for example, the following accounts:

	<u>Per</u> <u>1983 Report</u>	<u>Per</u> <u>Reconciliation</u>
State & Local Taxes	\$ 47,924	\$ 59,194
Federal Income Taxes	35,538	24,268
Other Federal Taxes	31,780	31,780
	<u>\$ 115,242</u>	<u>\$ 115,242</u>

TEST PERIOD

Leslie County proposed and the Commission has accepted the 12-month period ending December 31, 1983, as the test period in this matter.

VALUATION

Net Investment Rate Base

Leslie County at the hearing proposed a revised net investment rate base of \$7,386,932.⁶ The Commission has adjusted this rate base to exclude the telephone plant acquisition adjustment of \$6,334 in accordance with its policy that ratepayers should not be required to provide a return on that portion of plant acquired above book value. The Commission has further adjusted the proposed rate base by the amount of deferred investment tax credits at the end of 1983 of \$104,517. Therefore, Leslie County's adjusted net investment rate base is as follows:

Telephone Plant in Service	\$6,424,659
Construction Work in Progress	3,159,612
Materials and Supplies	21,877
Prepayments	1,416
Subtotal	<u>\$9,607,564</u>
Less:	
Accumulated Provision for Depreciation and Amortization	\$2,226,966
Deferred Investment Tax Credits	104,517
Subtotal	<u>\$2,331,483</u>
Net Investment Rate Base	\$7,276,081

⁶ T.E., September 19, 1984, page 17.

Capital Structure

The Commission finds from the 1983 Annual Report that Leslie County's total capital at the end of the test period was \$7,425,662 and consisted of \$825,497 in equity and \$6,600,165 in long term debt outstanding to the Rural Electrification Association ("REA") and the Rural Telephone Bank ("RTB").

The Commission has given due consideration to Leslie County's capital structure, net investment rate base and other elements of value in determining the reasonableness of the rate increase requested herein.

REVENUES AND EXPENSES

Leslie County had net operating income of \$316,902⁷ for the test period. As mentioned previously, Leslie County submitted a pro forma statement of income and expenses which reflected a pro forma net operating income of \$524,857 assuming the requested increase was granted. The Commission has not accepted Leslie County's pro forma statement which included assumed 9.9 percent increases in various accounts⁸ and wage increases which were not known and measurable even as of the hearing date.⁹ The Commission has made the following additional adjustments to Leslie County's test period operations:

⁷ Response to Question 8 filed 10/25/84, op. cit.

⁸ T.E., September 18, 1984, page 70.

⁹ T.E., September 19, 1984, page 4.

Maintenance Expenses

Leslie County had maintenance expenses for right-of-way clearing of \$217,230¹⁰ for 1983. Leslie County's witness, Mr. Edward Mattingly, testified that extensive right-of-way clearing is not performed every year, that the amount of this expense for 1983 was unusual and would occur only every 5 to 7 years, and that the most recent clearing began in 1982.¹¹ Leslie County stated that actual expense for right-of-way clearing was \$14,216 for 1981 and \$77,382 for 1982. As proper rate-making theory dictates that rates should be based on normal operations, the Commission has normalized the actual right-of-way clearing expenses for the period 1981-1983 over 5 years, resulting in a normalized right-of-way clearing expense of \$61,765,¹² an adjustment of \$155,465. Although right-of-way data for earlier years were not available, an examination of the account in which these expenses are recorded reveals that the amount of this account was minimal for 1979 and 1980¹³ and would not significantly affect the above adjustment.

Employee Concession Service

In response to staff requests, Leslie County stated that \$2,175 of concession telephone service was provided for Leslie

¹⁰ Post-Hearing Response, Question 1.

¹¹ T.E., September 18, 1984, pages 20-23.

¹² $\$14,216 + \$77,382 + \$217,230 = \$308,828 \div 5 = \$61,765$.

¹³ T.E., September 19, 1984, page 5.

County's employees.¹⁴ Leslie County's witness, Mr. Donald Roark, testified that such concession service is not considered in wage negotiations with employees.¹⁵ The Commission is of the opinion that the ratepayers should not be required to pay the costs of employee concession service as no tangible benefits accrue to the ratepayers. Therefore, the Commission has increased Leslie County's test period revenue by \$2,175 to include the revenue which would have been realized in the absence of these employee discounts.

Revenue Normalization

Leslie County had total operating revenues of \$1,645,315 for the test period, including Cable TV pole attachment revenues of \$2,340 which Leslie County treated as below-the-line revenues.¹⁶ The Commission is of the opinion that these revenues should be reflected above-the-line because these revenues are generated from use of the regulated telephone plant. Therefore, the Commission has increased test-period operating revenues by \$2,340.

In addition, the Commission has increased Leslie County's test period local service revenues by \$6,778 to reflect the annualized revenue based on the level of customers at the end of the test period.

¹⁴ Response to first staff request, dated July 12, 1984, item 14.

¹⁵ T.E., September 19, 1984, page 9.

¹⁶ Post-Hearing Response, Item 13.

Health Insurance Expense

Mr. Roark testified that the monthly charge for health insurance expense increased from \$2,600 to \$3,386 effective March 15, 1984.¹⁷ The Commission has allowed this adjustment because it meets the criterion of being known and measurable; therefore, operating expenses have been increased by \$9,432.¹⁸

Advertising Expenses

Leslie County had advertising expenses of \$1,606 for the test period. Examples of this advertising indicated that the majority of this expense was for institutional advertising as opposed to informational advertising. The Commission will allow the advertising expenses related to access charges of \$545 because of its informational nature; however, the remainder of advertising expenses of \$1,061 has been disallowed as Leslie County has failed to justify this expense as a proper rate-making item which provides material benefit to the ratepayers.

Contributions

Leslie County included in operating expenses contributions of \$2,302 and miscellaneous awards totalling \$500. Leslie County's witness, Mr. William Myers, admitted that it would not be appropriate for the ratepayers to bear the expense of these items.¹⁹ The Commission, upon review of these items, is of the

¹⁷ T.E., September 19, 1984, page 41.

¹⁸ $\$786 \times 12 = \$9,432.$

¹⁹ T.E., September 19, 1984, page 56.

opinion that both the charitable contributions and the miscellaneous awards were not of material benefit to the ratepayers and should, therefore, be borne by the stockholders of Leslie County; therefore, operating expenses have been reduced by \$2,802.

Amortization of Acquisition Adjustment

Leslie County included in its audited test period results the current year's amortization of its acquisition adjustment. Since the Commission has disallowed the inclusion of this adjustment in Leslie County's rate base, the Commission is of the opinion that this associated expense should also be disallowed. Therefore, the Commission has reduced Leslie County's test period expenses by \$2,936.

End-of-Period Interest During Construction

At December 31, 1983, Leslie County had construction work in progress ("CWIP") of \$3,159,612, of which \$3,018,695 was long term CWIP on which interest during construction ("IDC") is applied. As the purpose of IDC is to match cost and benefit, it is unfair to require Leslie County's ratepayers to pay a current cash return on plant not used and useful. Therefore, the Commission has adjusted Leslie County's actual IDC capitalized during the test period of \$64,988 by \$55,768 for total IDC of \$120,756²⁰ which reflects the annualized end-of-period IDC on the December 31, 1983, balance in long-term CWIP.

²⁰ 1983 Annual Report.

Moreover Leslie County proposed IDC as a below-the-line offset to interest charges. In accordance with past policy, the Commission has reflected total IDC above the line in operating revenues, an increase to operating revenues of \$120,756.²¹

Interest Charges

Leslie County proposed adjustments to test period interest charges of \$244,492 to annualize interest expense on long-term debt outstanding at the end of the test year, to reflect the interest on loan funds of \$986,000 drawn down approximately 10 months after the close of the test period, and to reflect the interest on estimated fund advances for the 4th quarter of 1984, for total pro forma interest charges of \$366,000.²² The gross interest charges of \$244,492 consisted of \$64,988 of IDC, \$178,965 of test period interest expense on long-term debt, and \$539 of other interest. Leslie County's pro forma interest charges of \$366,000 consisted of \$66,000 of IDC and \$300,000 of interest expense on long term debt.²³

The Commission's policy regarding investor-owned utilities which are engaged in construction programs is to allow adjustments to reflect normalized revenues and expenses as of the end of the test period but to disallow adjustments associated with additions

²¹ \$10,063 (December 1983 IDC) X 12 = \$120,756.

²² Post-Hearing Response, Question 18.

²³ Pro forma Statement of Income and Expenses, op. cit.

to plant subsequent to the test period. This policy is based on the rate-making principle of matching used and useful plant investment with the revenues and expenses generated by that plant investment. Leslie County's adjustment to interest charges to include post-test-period debt in the determination of pro forma interest would create a mismatch between the plant investment and the corresponding revenues and expenses. Therefore, the Commission has allowed gross interest charges on debt as of the end of the test period in the amount of \$306,730, but has disallowed interest expense of \$59,270 on additional debt subsequent to the end of the test period.

Income Tax Expense

The income tax effect of the Commission's adjustments to Leslie County's test period operating income is an increase to income tax expense of \$49,016, which includes the tax effect of the Commission's recognition of the increased interest charges of \$306,730 as of the end of the test period.

The effect of the Commission's adjustments on Leslie County's net income is as follows:

	<u>Actual Test Period</u>	<u>Commission Adjustments</u>	<u>Adjusted</u>
Operating Revenues	\$1,645,315	\$ 129,709	\$1,775,024
Operating Expenses	<u>1,328,413</u>	<u>(103,816)</u>	<u>1,224,597</u>
Operating Income	\$ 316,902	\$ 233,525	\$ 550,427
Other Income	18,151	-0-	18,151
Interest Expense	<u>179,504</u>	<u>127,226</u>	<u>306,730</u>
Net Income	<u>\$ 155,549</u>	<u>\$ 106,299</u>	<u>\$ 261,848</u>

REVENUE REQUIREMENTS

Leslie County is an investor-owned utility which is financed chiefly by long-term debt from the REA and the RTB, similar to the capital structures of many telephone cooperatives. The Commission has consistently determined revenue requirements for telephone cooperatives based on a return on net investment rate base and a Times Interest Earned Ratio ("TIER"). The Commission determines the TIER based upon the calculation provided in the REA mortgage agreement, section 5, which bases the coverage on net income before interest charges.

Leslie County's rate of return witness, Mr. William Myers, testified that revenue requirements for Leslie County should be based on maintenance of an acceptable TIER in order to meet REA requirements, rather than using rate of return as a primary focus.²⁴ Mr. Myers further stated that a minimum TIER of 1.5 was necessary and that a TIER ranging from 1.5 to 2.0 would be acceptable.²⁵ Upon cross-examination, Mr. Myers did not dispute the fact that the recommended TIER coverage and the resulting rate of return would produce an extraordinarily high rate of return on equity, but reiterated his position that the REA requirements were the first priority to be considered in this instance.²⁶

²⁴ T.E., September 19, 1984, pages 47-48.

²⁵ Ibid.

²⁶ Ibid., pages 61-62.

Mr. Myers stated that test period results as adjusted by Leslie County resulted in a TIER of 1.3.²⁷ However, the adjusted net operating income of \$550,427 resulting from the Commission's adjustments to Leslie County's test period operations results in a TIER coverage on gross interest of 1.79.²⁸ The Commission normally allows a TIER coverage of 1.5 for telephone cooperatives. However, the Commission is of the opinion that a TIER coverage of 1.79 is not unreasonable in this instance because of the uncertain effects of the ongoing construction program upon Leslie County's operations. Therefore, the Commission will not require a rate reduction in this instance. The Commission advises Leslie County to continue to monitor the effects of its ongoing construction program upon its financial results.

RATE DESIGN

Leslie County has proposed to establish various non-recurring charges for services which it has performed in the past and for which it has received no compensation. The new charges are a returned check charge, nuisance call trace charge, central office connection charge and a premises visit charge for customer-owned equipment. In addition, Leslie County proposed to establish monthly rates for call forwarding and call waiting. These new charges result in additional revenues of \$19,990.

²⁷ Ibid., page 45.

²⁸ $\$550,427 \div \$306,730 = 1.7945.$

Cost documentation that adequately supports the proposed rates and charges was filed by Leslie County. Therefore, the Commission is of the opinion that the proposed rates and charges for these services are fair, just and reasonable and should be approved.

SUMMARY

The Commission, after consideration of the evidence of record and being advised, is of the opinion and finds that:

1. The rates and charges proposed by Leslie County will produce revenues in excess of those found to be fair, just and reasonable herein and should be denied.

2. The proposed rates and charges as set out in the rate design section of this Order are fair, just and reasonable and should be approved.

3. All other rates and charges of Leslie County in effect under authority of the Commission prior to this date should continue in effect.

IT IS THEREFORE ORDERED that the rates and charges requested by Leslie County be and they hereby are denied.

IT IS FURTHER ORDERED that the rates and charges for non-recurring services in Appendix A be and they hereby are approved for service rendered on and after the date of this Order.

IT IS FURTHER ORDERED that all other rates and charges of Leslie County in effect under authority of the Commission prior to this date should continue in effect.

IT IS FURTHER ORDERED that Leslie County shall file with the Commission within 30 days of the date of this Order its revised tariff sheets setting forth the rates and charges approved herein.

Done at Frankfort, Kentucky, this 23rd day of January, 1985.

PUBLIC SERVICE COMMISSION

Richard D. Herman, Jr.
Chairman

Robert D. Spafford
Vice Chairman

Frank Shull
Commissioner

ATTEST:

Secretary

APPENDIX A

APPENDIX TO AN ORDER OF THE PUBLIC SERVICE COMMISSION IN CASE NO. 9002 DATED 1/23/85

The following charges are approved for all customers in the area served by Leslie County Telephone Company, Inc. All other rates and charges not specifically mentioned herein shall remain the same as those in effect under authority of the Commission prior to the effective date of this Order.

MISCELLANEOUS SERVICES CHARGES (ALL EXCHANGES)

<u>Item</u>	<u>Non-recurring Charge</u>
Return Check Charge	\$10.00
Nuisance Call Trace Charge	25.00
Central Office Service Connection Charge	10.00
 Premises Visit Charge	
Customer Caused Trouble	25.00
Customer Owned Equipment	25.00

AUXILIARY EQUIPMENT CHARGES (All EXCHANGES)

	<u>Monthly Rate</u>
Call Forwarding	\$ 1.40
Call Waiting	1.40